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HOW GOOD AN INVESTMENT IS A LEASEBACK ?

A relatively new form of real estate transaction which came to the front at a fast rate during the recent low interest rate period is the sale and leaseback type of transfer. We have been asked to chart and comment on the actual net return to the investor under such an arrangement.

While the sale and leaseback of corporate property is not new, this type of financing has received wide publicity and a strong stimulus by the entry of insurance companies into the field in the middle forties. Generally, the motives on the part of the vendor-tenant for entering into these transactions have been either to obtain income tax relief or liberal financing, or both. For the investors, the sales and leasebacks can represent sound investments, as the terms usually run from 20 to 40 years with fair rates of interest and reliable tenants.

Let us look at a typical example of a sale and leaseback between a corporation and an investor. The corporation (with triple A credit), having recently purchased property for $100, 000 and having constructed a $300, 000 building, sells the entire property at market value to the investor. The investor in turn leases the property back to the corporation for 20 years at an annual rental sufficiently large to pay back the $400, 000 at 4½% interest. This annual rental is amortized over the period of the lease, and in this case would be $30, 750. At the end of the 20-year period the lease may provide for an option to repurchase the property or renew the lease. Either alternative must be at a reasonable market value, and the original lease is generally limited to 30 years or else the transaction would not be considered a bona fide sale for tax purposes. For our example we will assume that the tenant-corporation will pay all costs of maintenance, repairs, taxes, and insurance. Also, for tax purposes, depreciation on the building will be assumed to be straight line, 2½% per annum.

The tenant-corporation has the immediate advantage of having its $400, 000 as working capital instead of being a fixed asset in real estate. In effect, the corporation has secured a loan for the value of the property without any indebtedness showing on its financial statement. By the sale and leaseback, the depreciation of $7, 500 per annum on the building is lost as an income tax deduction, but this loss is more than offset by the fact that now the $30,750 annual rental is fully deductible. Being still a tenant at the end of the lease term, the corporation would have to repurchase the property at its market value or extend the lease on a mutually acceptable basis if it wished to remain in business at that location.

From the point of view of the investor or purchaser, a sale and leaseback transaction can also be a good thing. Using the same example, let us see what the investor receives for his \$400,000. He has made a long-term investment in a piece of real estate that has a favorable lease with a top-grade tenant. Not only does he have faith in the tenant-corporation, but also the property in question is undoubtedly in a prime location. Because of the low risk involved, the investor is willing to accept only $4\frac{1}{2}\%$ return on his capital. For income tax purposes, the annual depreciation of \$7,500 on the building is now the investor's to deduct. However, the full amount of the rental, \$30,750, is subject to taxation.

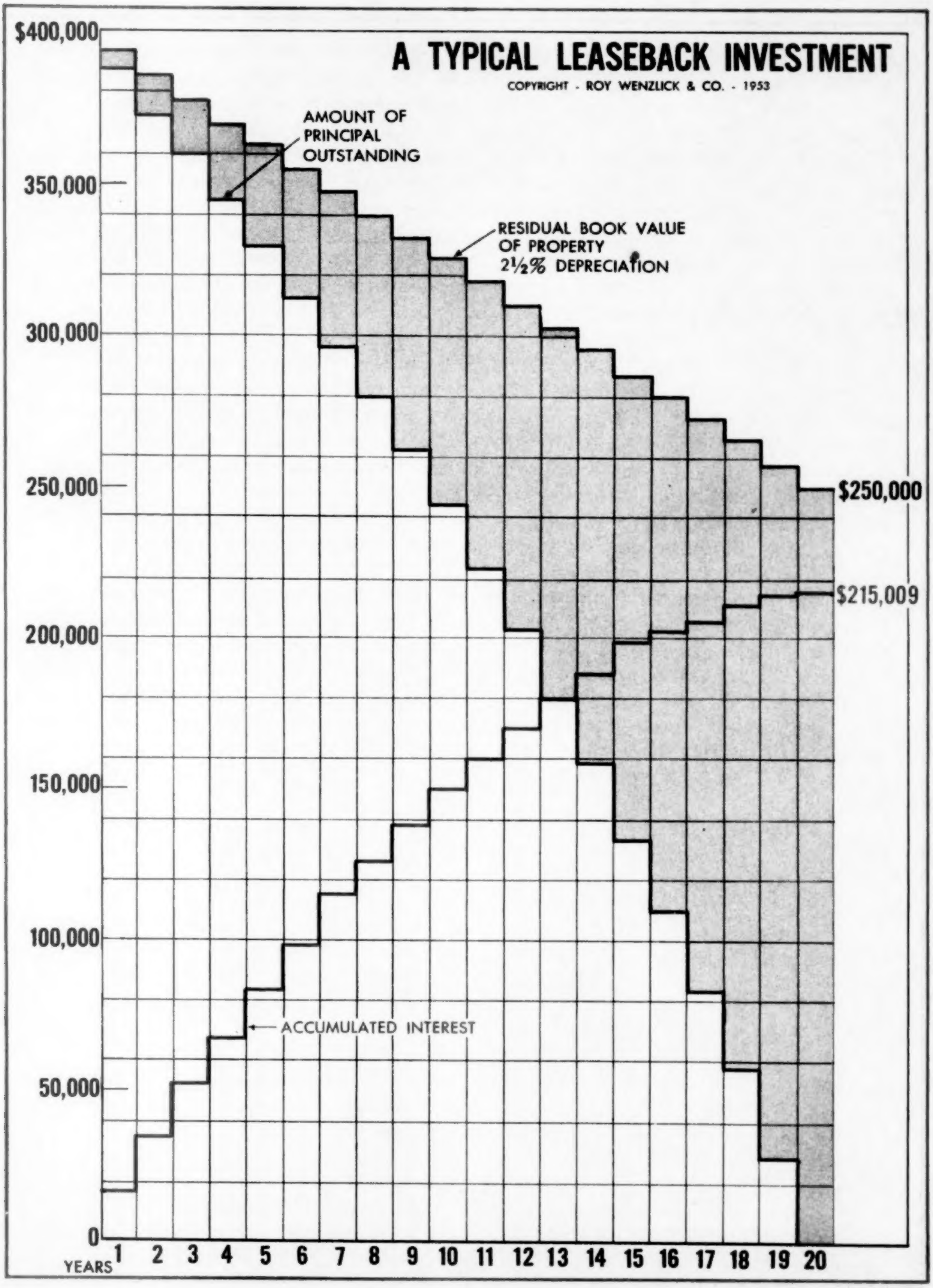
The chart opposite shows the returns that an investor would have under the example cited above. One line shows the "amount of principal outstanding" at the end of each year until the twentieth year, when the last of the principal has been repaid. The ascending line shows the total "accumulated interest" at the end of each year until the twentieth year, when a total of \$215,009 interest has been received on the original investment of \$400,000.

The top line on the chart represents the residual "book value" of the land and buildings, assuming that a straight $2\frac{1}{2}\%$ per year depreciation is used on the building which was new at the time of the original investment. This illustration shows a final residual value at the end of 20 years of \$250,000 (\$100,000 land, plus \$150,000 building). Actually, however, there is a good probability that the property would be worth considerably more than this figure, as the depreciation rate is high, and the land may even increase in value, depending on the district. Another factor to consider is that 20 years from now we more than likely will again be in a period near the top of the real estate cycle rather than near the bottom.

To consider the income after taxes to the investor, let's assume that he is an individual and has no other income. He would have the \$7,500 depreciation plus his own personal exemption and allowable expenses of \$1,600 to deduct. His net income after taxes would be \$21,650 per year for the duration of the lease (assuming taxes were to remain the same).

To evaluate the worth of this sale and leaseback to the investor, let us now assume that he invested his \$400,000 in land and a new building in a conventional manner. We are of the opinion that a fair overall capitalization rate today for this type of property is 6.8% (see Appraisal Bulletin, March 26, 1952, "Selection of Capitalization Rates"). Using this rate, he would be entitled to receive \$27,200 per year in rents plus depreciation of \$6,000, which is at a more realistic rate of 2%. The annual gross rental he would have to receive, then, would be \$33,200.

In computing income tax, we will again assume an individual with no other income and with \$7,500 deducted for depreciation (even though his rental is based on \$6,000 depreciation). The investor's net income after taxes would be \$23,155, as compared with \$21,650 under the sale and leaseback transaction. From this comparison it appears that, all other things being equal, the conventional invest-


A TYPICAL LEASEBACK INVESTMENT
COPYRIGHT - ROY WENZLICK & CO. - 1953
$400,000
350,000
300,000
250,000
200,000
150,000
100,000
50,000
0
AMOUNT OF PRINCIPAL OUTSTANDING
RESIDUAL BOOK VALUE OF PROPERTY 2½% DEPRECIATION
ACCUMULATED INTEREST
$250,000
$215,009
YEARS 1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20

ment is slightly better than the leaseback investment. However, for the higher return, the investor has a slightly higher risk in that he must secure and keep good tenants, while under the leaseback the occupancy is virtually guaranteed.

When carefully planned, the sale and leaseback type of real estate transaction can be attractive to both the investor and the tenant-corporation. The various clauses and options in the lease are very important in this respect, and in most instances the agreements reached are more complicated than our simple illustration indicates. Some of the sale and leaseback transactions which we have examined provide for several renewal periods at the option of the lessee, and at much lower rentals than those established for the first period of the lease.

The main stumbling block to further expansion of the sale and leaseback type of transaction is the unwillingness of investors to accept lower interest rates or unfavorable renewal and repurchase options which are being sought by the vendor-lessees. On the other hand, a triple A credit corporation has little difficulty in obtaining satisfactory loans at lower interest rates than those expected by investors interested in a sale and leaseback. One other factor which may be holding down the volume of sales and leasebacks is the tax situation, as there are not many clear-cut decisions on some of the income tax features involved.

In spite of these difficulties, however, under certain conditions sale and leaseback can be mutually acceptable to the investor and to the corporation by a careful balancing of the various clauses and options contained in the lease. The appraiser, when called upon to evaluate real estate under a sale and leaseback, should familiarize himself with all of the terms of the lease and should also consider the property as if it were conventionally leased and financed. However, the value of the property hinges on the terms of the lease, as the worth of the property will be based on its future earnings.